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In the Supreme Court of the United States

OCTOBER TERM, 1977

EMMETT E. NORTON AND FRANCES G. NORTON,
PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

BRIEF FOR THE UNITED STATES IN OPPOSITION

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OPINION BELOW

The opinion of the Court of Claims (Pet. App. A-1 to A-10) is reported at 551 F.2d 821.

JURISDICTION

The judgment of the Court of Claims was entered on March 23, 1977 (Pet. App. A-1, A-10), and the court's order denying petitioner's motion for rehear-

ing *en banc* was entered on April 29, 1977 (Pet. App. B-1). The petition for a writ of certiorari was filed on June 9, 1977. The jurisdiction of this Court is invoked under 28 U.S.C. 1255.

QUESTION PRESENTED

Whether the Court of Claims correctly held that petitioner, who was engaged in the business of cutting and selling timber, received ordinary income and not capital gain when he assigned his rights under a timber-cutting contract.

STATUTES INVOLVED

The pertinent provisions of Section 1221 and 1231 of the Internal Revenue Code of 1954 (26 U.S.C.) are set forth in the Appendix, *infra*, pp. 1A to 4A.

STATEMENT

During 1968 and 1969, petitioner [1] was engaged in the business of cutting and selling timber. On January 30, 1968, he entered into a timber-cutting contract with the United States Forest Service under which he acquired the right (and obligation) to cut and purchase certain timber located in the South Tongass National Forest in Alaska (Pet. App. A-2). This agreement, known as the Turn Point contract,

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[1] "Petitioner" refers to Emmett E. Norton. Frances G. Norton is a party solely because she filed joint income tax returns with her husband for the years in issue (Pet. App. A-2).

provided that the Forest Service would continue to hold "all right, title, and interest" in the timber covered by the contract until the timber was "cut, scaled, and paid for," at which time title would pass to petitioner (Pet. App. A-2; Pltf. Ex. 1, p. 17). The price petitioner had to pay for the timber cut by him was fixed at $9.05 per thousand board feet of Sitka Spruce and $2.32 per thousand board feet of Western Hemlock and other types of timber (Pet. App. A-2; Pltf. Ex. 1, p. 3).

After petitioner entered into the Turn Point contract, he carried on his logging business in the South Tongass National Forest. During this period, petitioner's business consisted entirely of cutting or logging the standing timber covered by the Turn Point contract and selling this cut timber to the Ketchikan Pulp Company ("Ketchikan"), an unrelated Washington corporation (Pet. App. A-2). By March 19, 1969, petitioner had logged and sold to Ketchikan 9,919,040 board feet or approximately one-third of the estimated 30,000,000 total board feet of timber subject to petitioner's contract with the Forest Service (Pet. App. A-3).

In March, 1969, petitioner decided to conclude his independent logging activities. He sold all his logging equipment, machinery and supplies to Ketchikan, and on March 19, 1969, assigned his remaining rights under the Turn Point contract to Ketchikan for $127,500, payable at $8.50 per thousand board feet of logs produced (Pet. App. A-3). In connection with

its purchase of petitioner's rights under the Turn Point contract, Ketchikan executed a promissory note agreeing to pay the aggregate sum of $127,500 "regardless of an over-run or under-run of the volume of timber" (Pltf. Ex. 3) covered by the contract (Pet. App. A-3).

Petitioner reported the income received by him from the assignment of the Turn Point contract as long-term capital gain (Pet. App. A-3). On audit, the Commissioner of Internal Revenue determined that the amounts received by petitioner from Ketchikan gave rise to ordinary income and not capital gain, because petitioner's assignment of his rights under the Turn Point contract did not involve the sale or exchange of a capital asset (Pet. App. A-3 to A-4). Petitioner paid the resulting deficiencies, and brought this refund suit in the Court of Claims.

After analyzing the terms of the Turn Point contract and the function of the contract as part of petitioner's logging business, the Court of Claims concluded that the income realized by petitioner on the contract "d[id] not qualify as gain from the sale of a capital asset" under Section 1221 of the Code (Pet. App. A-1). The court also held that since the Turn Point contract did not give petitioner a present interest in any standing timber, petitioner's assignment of the contract to Ketchikan could not qualify for capital gain treatment as a sale of real property used in his trade or business under Section 1231 of the Code (Pet. App. A-5 to A-10).

ARGUMENT

1. The Court of Claims correctly held that the income realized by petitioner on the Turn Point contract was taxable as ordinary income rather than capital gain. As this Court observed in *Malat* v. *Riddell*, 383 U.S. 569, 572, the theory underlying the capital gain provisions of the Code is "to differentiate between the 'profits and losses arising from the everyday operation of a business' on the one hand (*Corn Products Co.* v. *Commissioner*, 350 U.S. 46, 52) and 'the realization of appreciation in value accrued over a substantial period of time' on the other. (*Commissioner* v. *Gillette Motor Co.*, 364 U.S. 130, 134.)."

Section 1221 of the Code, which defines "capital asset" for tax purposes, therefore specifically excludes certain classes of business-related property from capital gains treatment. For example, Section 1221(1), provides that the term "capital asset" does not include any "stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." See, *e.g.*, *Huxford* v. *United States*, 441 F. 2d 1371 (C.A. 5); *Crosby* v. *United States*, 414 F. 2d 822, 825-827 (C.A. 5); *Wineberg* v. *Commissioner*, 326 F. 2d 157, 160-164 (C.A. 9); *Patterson* v. *Belcher*, 302 F. 2d 289, 292-295 (C.A. 5), certiorari denied, 371 U.S. 921.

Section 1231 of the Code, which extends capital gains treatment to certain types of "property used in the trade or business" of a taxpayer, likewise excludes

"property of a kind which would properly be includible in inventory of the taxpayer if on hand at the close of the taxable year," and "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." Sec. 1231(b)(1)(A) and (B), Internal Revenue Code of 1954. See *Huxford* v. *United States*, *supra*, 441 F. 2d at 1374-1375. See also, *International Shoe Machine Corp.* v. *United States*, 491 F. 2d 157 (C.A. 1), affirming, 360 F. Supp. 588 (D. Mass.); *Harrah* v. *Commissioner*, 30 T.C. 1236.

Here, petitioner was engaged in the business of cutting and selling timber. Under his contract with the Forest Service, he had the exclusive right to cut and purchase certain timber located on the Turn Point range which he, in turn, then sold to Ketchikan. The Turn Point contract represented the form in which petitioner acquired the stock in trade or inventory of his timber business. See, *e.g.*, *S. S. Pierce* v. *United States*, 57-2 U.S.T.C., par. 9886, decided July 18, 1957. (D. Mass.). When petitioner assigned his rights under the Turn Point contract to Ketchikan for $127,500, he was simply selling off his interest in this business inventory. Contrary to petitioner's assertion (Pet. 7-10), his assignment of the contract was therefore specifically excluded from capital gains treatment by the statutory exceptions in Sections 1221(1) and 1231(b)(1) of the Code for "property of a kind which would be includible in * * * inventory."[2]

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[2] *Commissioner* v. *Ferrer*, 304 F. 2d 125 (C.A. 2), upon which petitioner relies (Pet. 8-9), is not to the contrary. Even assuming that the Turn Point contract gave petitioner an

Moreover, as this Court's decision in *Corn Products Co.* v. *Commissioner*, 350 U.S. 46, 52, demonstrates, it does not matter that the timber cutting contract itself did not represent "actual inventory." There, the taxpayer purchased corn futures (*i.e.*, contracts for the future delivery of corn) in order to insure that it would have an " 'adequate supply of raw corn' " for its corn products business (350 U.S. at 48). The corn futures in *Corn Products* served much the same function as petitioner's Turn Point timber cutting contract. In holding that the gains the Corn Products Company realized when it sold these futures fell within the exclusion from capital gains now set forth in Sections 1221(1) and 1231(b)(1) of the Code, the Court pointed out (350 U.S. at 54) that "if a sale of the future created a capital transaction while delivery of the commodity under the same future did not, a loophole in the statute would be created and the purpose of Congress frustrated." See *S. S. Pierce* v. *United*

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equitable interest in the timber covered by the agreement, and that this was a relevant consideration, the timber itself would not have qualified as a "capital asset" in petitioner's hands. Petitioner was in the trade or business of cutting and selling timber and Section 1221(1) provides that the term "capital asset" does not include stock in trade, property that would normally be included in inventory, or property held primarily for sale to customers in the ordinary course of the taxpayer's business. *Huxford* v. *United States*, 441 F. 2d 1371 (C.A. 5); *Crosby* v. *United States*, 414 F. 2d 822, 825-827 (C.A. 5); *Wineberg* v. *Commissioner*, 326 F. 2d 157, 160-164 (C.A. 9). See *Commercial Solvents Corp.* v. *United States*, 427 F. 2d 749 (Ct. Cl.) certiorari denied, 400 U.S. 943; *Coleman* v. *United States*, 388 F. 2d 337 (Ct. Cl.).

States, supra; Buena Vista Farms, Inc. v. *Commissioner*, 68 T.C. No. 34, decided June 20, 1977.[3]

Petitioner therefore errs in suggesting (Pet. 10, 12-13, 13-14) that it makes any difference that his assignment of the Turn Point contract was a one-time event that was part of the liquidation of his timber cutting business. For even when a taxpayer liquidates or sells a business, it is necessary for him to account for his inventory and stock in trade separately as non-capital assets. *Williams* v. *McGowan*, 152 F. 2d 570 (C.A. 2); *J. R. Simplot Co.* v. *Commissioner*, 26 T.C.M. 488. See also *Crosby* v. *United States, supra; Buena Vista Farms, Inc.* v. *Commissioner, supra.* Accordingly, the Court of Claims properly held that the amount received by petitioner on the assignment of the Turn Point contract was taxable as ordinary income because these funds were simply a "substitute for what would otherwise be received at a future time as ordinary income." *Commissioner* v. *P.G. Lake, Inc.*, 356 U.S. 260, 265.

2. Petitioner errs in suggesting (Pet. 14-15) that the parties "agreed" (Pet. 14) in the court below that

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[3] Both Section 1221(1) and 1231(b)(1)(A) provide that capital asset treatment is not available with respect to "property of a kind which *would* properly be included in the inventory of the taxpayer, *if* on hand at the close of the taxable year * * *." (Emphasis added.) In *S.S. Pierce* v. *United States, supra*, the district court therefore held that a taxpayer's sale of certain warehouse receipts held by it were within the statutory exclusion now found in Section 1221(1), which the court rephrased as covering " 'property of a kind

the Turn Point contract represented "real property used in the petitioner[']s trade or business within the purview of Section 1231" of the Code. As the Court of Claims stated (Pet. App. A-4 to A-6), both petitioner and the government presented alternative contentions below, and each seemed to recognize that it was possible for the court to conclude, as it did, that the Turn Point contract did not give petitioner a present interest in any real property or standing timber. Moreover, whether such a contract involves a present transfer of a vested interest in standing timber depends on the facts and circumstances of each case. See *Jantzer* v. *Commissioner*, 284 F. 2d 348, 355-357 (C.A. 9). Compare *J.R. Simplot Co.* v. *Commissioner*, 26 T.C.M. 488, with *Barclay* v. *United States*, 333 F. 2d 847 (Ct. Cl.).

Here, while the Turn Point contract gave petitioner a right to cut and purchase certain timber, it also provided that the Forest Service would continue to hold title to the timber until it was cut and paid for, and that the Forest Service would bear the risk of loss during this period (Pet. App. A-2, A-5 to A-6). As the Court of Claims noted, these circumstances are "indicat[ive of] an intent that no present interest in real property, the standing timber, passed to" petitioner (Pet. App. A-5 to A-6). Accord: *J. R. Simplot Co.* v. *Commissioner*, *supra*.

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which [not only was in fact included, but also] would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year' " (57-2 U.S.T.C., at p. 58,168).

At all events, even if the Turn Point contract could be deemed to have given petitioner an interest in real property in the form of standing timber, petitioner's assignment of the contract to Ketchikan still would not qualify for capital gain treatment under Section 1231 of the Code. Section 1231(b)(1) precludes timber and other real property used in a taxpayer's trade or business from qualifying as a Section 1231 asset if the property in question is "of a kind of which would properly be includible in inventory of the taxpayer" or "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." Sec. 1231(b)(1)(A) and (B).[4] See *Hux-*

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[4] As a result of certain particularized provisions of the Internal Revenue Code, timber sales can qualify for capital gain treatment under Section 1231(b)(2) if the conditions of Section 631(b) of the Code are met. In general, Section 631(b) relates to transfers where an owner of timber retains an "economic interest" in timber sold by him under contract. See *Ray* v. *Commissioner*, 32 T.C. 1244, affirmed *per curiam*, 283 F. 2d 337 (C.A. 5). See also *Wineberg* v. *Commissioner*, 326 F. 2d 157 (C.A. 9). Petitioner, however, conceded in the court below (Pet. App. A-3 n. 4) that his assignment of his rights under the Turn Point contract to Ketchikan did not qualify for special treatment under Sections 631(b) and 1231(b)(2) of the Code. One of the reasons that the assignment did not qualify under Section 631(b) was that petitioner did not retain any "economic interest" in the Turn Point contract when he conveyed it to Ketchikan; according to the terms of his agreement with Ketchikan, petitioner was to be paid $127,500 for his rights under the contract irrespective of any overruns or underruns (see Pet. App. A-3 n. 4).

ford v. *United States*, *supra*, 441 F. 2d at 1374-1375; *Nash* v. *Commissioner*, 60 T.C. 503, 515-517 .

3. Finally, petitioner points out (Pet. 15-16) that this Court's decision in *Corn Products Co.* v. *Commissioner*, *supra*, has not been uniformly applied by the lower courts. Several courts have even held on the authority of *Corn Products* that capital stock in a corporation might not qualify as a capital asset under certain circumstances not specified in Section 1221 of the Code. See, *e.g.*, *Booth Newspapers, Inc.* v. *United States*, 303 F. 2d 916 (Ct. Cl.); *Waterman, Largen & Co.* v. *United States*, 419 F. 2d 845 (Ct. Cl.), certiorari denied, 400 U.S. 869; *Steadman* v. *Commissioner*, 424 F. 2d 1 (C.A. 6), certiorari denied, 400 U.S. 869; *Schlumberger Technology Corp.* v. *United States*, 443 F. 2d 1115 (C.A. 5).

Those decisions have read *Corn Products* as creating a nonstatutory category of property that will qualify as a capital asset (see, *e.g.*, *Booth Newspapers, Inc.* v. *United States*, *supra*, 303 F. 2d at 920; *Waterman, Largen & Co.* v. *United States*, *supra*, 419 F. 2d at 846-847). But whether or not those cases were correctly decided, the decision in this case does not depend upon such nonstatutory considerations. Here, as in *Corn Products*, the property in question was specifically excluded from capital gains treatment because it represented the form in which the taxpayer acquired the stock in trade or inventory of a business. Under these circumstances, this is not an appropriate case for consideration of the proper scope of the *Corn*

Products decision,[5] because its facts are analytically indistinguishable from those of *Corn Products*.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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[5] Petitioner acknowledges (Pet. 17) that the Court of Claims never considered the impact of the so-called post-*Corn Products* decisions on Section 1231 of the Code. As a result, this is not an appropriate case in which to resolve what petitioner describes (Pet. 17-18) as an "apparent conflict" between the Ninth Circuit's decision in *Hollywood Baseball Assn.* v. *Commisioner*, 423 F. 2d 494 (C.A. 9), certiorari denied, 400 U.S. 848, and the decision of the district court in *Deltide Fishing & Rental Tools, Inc.* v. *United States*, 279 F. Supp. 661 (E.D.La.), over the role that *Corn Products* should play under Section 1231. Moreover, there is no conflict between circuits on this point. Contrary to petitioner's suggestion (Pet. 17), the Court of Claims has never actually decided the issue. See, *e.g.*, *Grant Oil Tool Co.* v. *United States*, 381 F. 2d 389 (Ct. Cl.).

APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 1221. CAPITAL ASSET DEFINED.

For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business;

(3) a copyright, a literary, musical, or artistic composition, or similar property, held by—

(A) a taxpayer whose personal efforts created such property, or

* * * * *

(C) a taxpayer in whose hands the basis of such property is determined, for the purposes of determining gain from a sale or exchange, in whole or part by reference to the basis of such property in the hands of a taxpayer described in subparagraph (A) * * *;

(4) accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1); or

(5) an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date nor exceeding one year from the date of issue.

SEC. 1231. PROPERTY USED IN THE TRADE OR BUSINESS AND INVOLUNTARY CONVERSIONS.

(a) [as amended by Sec. 49(a), Technical Amendments Act of 1958, Pub.L. 85-866, 72 Stat. 1642] *General Rule.*—If, during the taxable year, the recognized gains on sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be consid-

ered as gains and losses from sales or exchanges of capital asset. For purposes of this subsection—

(1) in determining under this subsection whether gains exceed losses, the gains described therein shall be included only if and to the extent taken into account in computing gross income and the losses described therein shall be included only if and to the extent taken into account in computing taxable income, except that section 1211 shall not apply; and

(2) losses upon the destruction, in whole or in part, theft or seizure, or requisition or condemnation of property used in the trade or business or capital assets held for more than 6 months shall be considered losses from a compulsory or involuntary conversion.

In the case of any property used in the trade or business and of any capital asset held for more than 6 months and held for the production of income, this subsection shall not apply to any loss, in respect of which the taxpayer is not compensated for by insurance in any amount, arising from fire, storm, shipwreck, or other casualty, or from theft.

(b) *Definition of Property Used in Trade or Business.*—For purposes of this section—

(1) *General rule.*—The term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, held for more than 6 months, and real property used

in the trade or business, held for more than 6 months, which is not—

(A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year,

(B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or

(C) a copyright, a literary, musical, or artistic composition, or similar property, held by a taxpayer described in paragraph (3) of section 1221.

(2) [as amended by Sec. 227(a)(2), Revenue Act of 1964, Pub.L. 88-272, 78 Stat. 97] *Timber, coal, or domestic iron ore.*—Such term includes timber, coal, and iron ore with respect to which section 631 applies.

(3) *Livestock.*—Such term also includes livestock, regardless of age, held by the taxpayer for draft, breeding, or dairy purposes, and held by him for 12 months or more from the date of acquisition. Such term does not include poultry.

(4) *Unharvested crop.*—In the case of an unharvested crop on land used in the trade or business and held for more than 6 months, if the crop and the land are sold or exchanged (or compulsorily or involuntarily converted) at the same time and to the same person, the crop shall be considered as "property used in the trade or business."

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